CLARION PARTNERS

Private real estate investing amid macro uncertainties

A unique and complex macro environment today

COVID has been a "black swan" event that severely disrupted normal market cycles and our daily lives starting in 2020. With breakthrough vaccines and unprecedented stimulus support, the global economy staged a strong synchronized demand recovery, which has also now resulted in historically high inflation in many countries. To curb inflation, central banks have commenced tightening financial market conditions by raising interest rates and through quantitative tightening (QT). As a result, the risk of a recession over the next 12 months has escalated.[1]

Notwithstanding these economic headwinds, there are still significant positive tailwinds that, when taken together, make the U.S. macro backdrop uncertain (Figure 1). National consumer spending, labor markets, business activity, corporate balance sheets and the banking system have all continued to be relatively healthy, with much lower leverage than before the Global Financial Crisis (GFC). In June 2022, all 33 of the largest financial institutions passed the annual stress test conducted by the Federal Reserve, suggesting a sound financial industry.

Clarion Partners is optimistic about the long-term outlook for the U.S economy and commercial real estate (CRE) performance. The Millennials and Gen Z, the largest generations in history, are entering their peak earning and spending years, which should drive demand growth and property appreciation over the next 10–15 years.

Figure 1: Macro investment dynamics

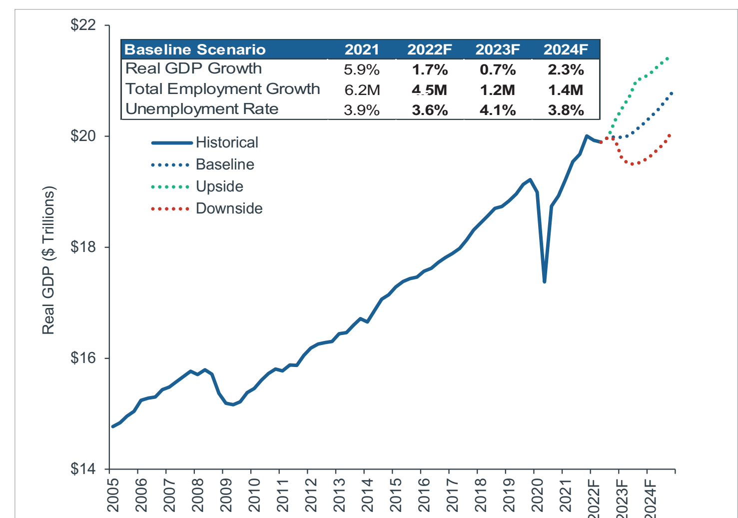
TAILWINDS	HEADWINDS/RISKS
Consumer spending holding up well	High inflation and interest rates
High household wealth / good income growth	Global energy crisis
Solid corporate & financial sectors	Recession risk
Strong job growth	Geopolitical tensions, especially the war in Ukraine
Generally low leverage (relative to the GFC)	Potential further COVID variants; China COVID risk
Innovations & ESG	High government debt level limits fiscal response
Improving supply chain issues	Labor shortage
Millennials / Gen Z & net migration	Affordability / wealth divide

Source: Clarion Partners Investment Research, October 2022

A recession or a soft landing?

Depending on how quickly inflation will respond to the Fed's tightening, several possible economic scenarios could play out over the next 1–2 years. Nonetheless, we do not believe that the coming slowdown will repeat the severity of the GFC. Moody's Analytics' baseline forecast for U.S. economic growth is generally positive, with an expected creation of 6.6 million new jobs from 2022 to 2024 (Figure 2). The current unemployment rate of 3.5 percent is near its all-time low. Under this baseline scenario, significant job loss is not expected over the next two years, which should bode well for real estate fundamentals. However, if the U.S. economy falls into a recession, we might see more substantial job loss, hurting consumer spending and lowering real estate rent growth.

Figure 2: Moody's real GDP & total employment growth forecasts



Moody's Analytics, Clarion Partners Investment Research, October 2022. Note: Real GDP in 2012 dollars.[2] Forecasts as of October 2022 and may be revised.

Real estate performed well during periods of rising interest rates

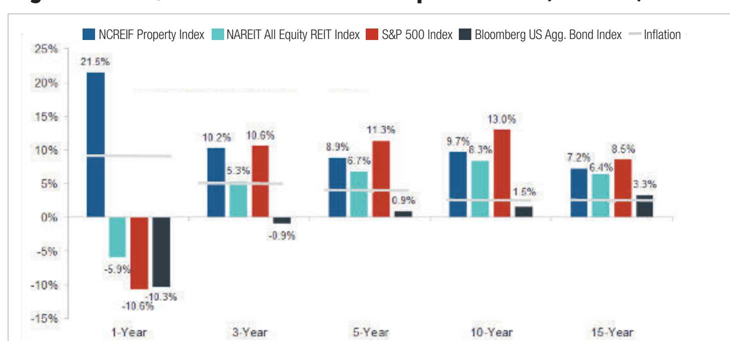
Since March 2022, the Fed has aggressively raised the target Fed funds rate to 3.0–3.25 percent and started QT by beginning to unwind its $9 trillion balance sheet, which will continue to reduce liquidity across the financial system. At the same time, the 10-year Treasury yield has also fluctuated between 3.5 percent and 4.0 percent in recent months, raising questions of how CRE will perform during this uncertain time.

Historically, U.S. CRE investment performance has reacted favorably in periods of rising interest rates. Rising interest rates are usually related to a strengthening of the U.S. economy, which often leads to higher demand for commercial space. An analysis of NCREIF Property Index (NPI) total returns shows that private core real estate investment performance was usually strong during periods of rising 10-year Treasury yield, as well as during the 12–18 months thereafter.

Private real estate has had strong recent performance

While the U.S. economic growth outlook has continued to moderate throughout 2022 amidst greater financial market volatility, private core real estate investment returns have remained largely resilient. Robust job and wage growth, along with historically low vacancy, have been key factors sustaining healthy property-level fundamentals. Over the past year, the NPI total return performance has been strong, outperforming the FTSE NAREIT All Equity Index, the S&P 500 Index, and the Bloomberg U.S. Aggregate Bond Index (Figure 3). Furthermore, over the past 15 years, private core real estate has proven to be a good hedge against inflation and provided diversification benefits within a mixed-asset portfolio due to very low or negative correlations with stocks and bonds.

Figure 3: Stock, bond & real estate return performance (Q2 2022)



Sources: NCREIF, NAREIT, Bloomberg, Moody's Analytics, Clarion Partners Investment Research, October 2022. Note: "Inflation" is the CPI Index; Return data are through Q2 2022; Q3 NPI total return data is not available yet.

Impact from shifting capital markets

The combination of higher inflation and rising interest rates will, nonetheless, likely continue to have a material yet varied impact on the U.S. CRE market. While property fundamentals have largely remained stable over the past several months, there have been some disruptions across real estate debt and equity capital markets. Ten-year financing costs have risen by approximately 200 bps year-to-date (through September), and higher financing costs, along with tighter lending standards, have added some upward pressure on cap rates and downward pressure on property values.

With these shifts and continued economic ambiguity, the CRE markets are in a period of price (re)discovery. Clarion Partners expects cap rates to expand; however, the magnitude will depend on various factors. The risk profile of individual assets (sector type, quality, market and lease terms) will matter significantly. Rent growth and higher replacement costs are likely to sustain net operating income (NOI) growth in the near future, which may offset — at least partially — the negative impacts from higher interest rates.

In addition, the future course of cap rate expansion will also be determined by the ultimate course of long-term Treasury rates, which may or may not already reflect the Fed's announced policy path. Today, there is a near-record amount of "dry powder" on the sidelines, and most owners are not over-leveraged. For these reasons, we believe that it is not likely that any CRE correction in the transaction market will be as severe as during the GFC.

From a market expectation viewpoint, the Q3 2022 PREA Consensus Forecast indicates a significant moderation to the near-term outlook for NPI total returns, clearly reflecting the broader slowdown in the U.S. economy and higher rate environment. Of course, the returns will likely vary greatly by sector, region and asset quality. We expect a continued dispersion in performance by sector, with industrial and apartment leading retail and office. We also believe alternative sectors, such as life sciences, single-family rentals (SFRs) and self-storage, have a positive outlook.

Summary

Clarion Partners believes that investors should take a long-term view during this period of uncertainty and remain patient. Current macro risks and market dislocations may also create attractive buying opportunities over the next 12 to 18 months. In the long run, we recommend that investors maintain an adequate allocation to CRE, which has proven to be an effective inflation hedge historically and which offers portfolio diversification benefits. As CRE transitions into the next market cycle, we also recommend positioning portfolios for better risk-adjusted performance with an overweight to property sectors and markets in which owners have strong pricing power and can grow cash flow over time.

[1]Moody's Analytics. Q3 2022. [2]Moody's Analytics, October 2022. Notes: This forecast was provided by Moody's Analytics as of 09/30/2022. Moody's believes that (i) the baseline forecast has a 50% probability that the economy will perform better or worse; (ii) the upside forecast has a 10% probability that the economy will perform better and a 90% probability it will perform worse; (iii) the downside forecast has a 90% probability the economy will perform better and a 10% probability it will perform worse. The upside and downside forecast scenarios are impacted by the geopolitical climate, oil prices, supply chain, and inflation resolving faster or slower than expected.

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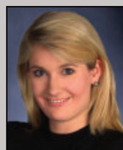

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CORPORATE OVERVIEW

Clarion Partners has been a leading U.S. real estate investment manager for more than 40 years. Headquartered in New York City, the firm has offices in major markets throughout the United States and Europe. With $81.4 billion in total assets under management as of June 30, 2022, Clarion Partners offers a broad range of both debt and equity real estate strategies across the risk/return spectrum to its more than 500 domestic and international institutional investors.

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